



BANK OF ENGLAND

# Record of the Financial Policy Committee Meeting on 3 October 2018

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This is the record of the Financial Policy Committee meeting held on 3 October 2018.

It is also available on the Internet: <https://www.bankofengland.co.uk/record/2018/financial-policy-committee-october-2018>

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is a committee of the Bank of England.

The FPC's next policy meeting will be on 28 November 2018 and the record of that meeting will be published on 11 December.

## Record of the Financial Policy Committee meeting held on 3 October 2018

At its meeting on 3 October 2018, the Financial Policy Committee (FPC):

- Continued to monitor risks of disruption to the supply of financial services to UK and EU households and businesses as the UK exited the EU. The FPC had been monitoring risks of disruption that could arise in the absence of an implementation period or any other agreement. There had been considerable progress in the UK to address these risks, but only limited progress in the EU. In the limited time remaining, it was not possible for companies on their own to mitigate fully the risks of disruption to cross-border financial services. The need for authorities to complete mitigating actions was now pressing.
- Continued to judge that the UK banking system would be strong enough to serve UK households and businesses through a disorderly, cliff-edge Brexit.
- Reiterated that, irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibility, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international baseline standards.
- Continued to judge that, apart from those related to Brexit, domestic risks remained at a standard level overall. The risk appetite of creditors remained strong. But financial conditions had tightened over the course of the year and borrower demand had been restrained. As a consequence credit growth had slowed. The Committee agreed that risks to the UK from global vulnerabilities remained material.
- Expressed concern about the rapid growth of leveraged lending, including to UK businesses. It would assess any implications for banks in the 2018 stress test and also review how the increasing role of non-bank lenders and changes in the distribution of corporate debt could pose risks to financial stability.
- Judged that, reflecting the substantial increase in its resilience over the past decade, the UK banking system now had the capacity to absorb, in addition to a disorderly, cliff-edge Brexit, further misconduct costs and stresses that could arise from intensifying trade tensions and a further sharp tightening of financing conditions for emerging markets.
- Given the current balance of risks, maintained the UK countercyclical capital buffer (CCyB) rate at 1%. The FPC would conduct, as normal, a comprehensive assessment of the

resilience of the UK banking system in the 2018 stress test and review the adequacy of the 1% CCyB rate at its meeting on 28 November.

- Concluded that, provided they were implemented as intended, the FCA's proposed reforms to open-ended commercial real estate funds were beneficial to UK financial stability. To be effective, suspensions needed to operate in a rapid and consistent manner. It agreed that the proposals were not a general solution to vulnerabilities in other open-ended funds.
- Agreed to delay the Bank's launch of the next biennial exploratory scenario (BES) to September 2019. The Bank expected to publish the results of this exercise alongside the *Financial Stability Report (FSR)* in June 2020.

1. The Committee met on 3 October 2018 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. To do so, the FPC discussed the risks faced by the UK financial system and assessed the resilience of the system to those risks. Its aim is to ensure the UK financial system is resilient to, and prepared for, the wide range of risks it could face – so that the system can serve UK households and businesses in bad times as well as good.

### **Financial stability risks arising from Brexit**

2. Consistent with its statutory duties, the FPC continued to identify and monitor UK financial stability risks associated with Brexit so that preparations could be made and actions taken to mitigate them. In this way, the FPC was aiming to promote an orderly adjustment to the new relationship between the UK and the EU. There were a range of possible outcomes for the future UK-EU relationship. Given its remit, the FPC was focused on outcomes that could have most impact on financial stability. That included outcomes in which there were barriers to providing financial services across the UK-EU.

3. In November 2017, the FPC had published a checklist of actions that would mitigate risks of disruption to important financial services used by households and businesses to support their economic activity. It had since updated its judgements of progress against this checklist on a quarterly basis.

4. At its meeting, the FPC reviewed progress against those actions. As previously, its judgement reflected the underlying scale of disruption to end-users, taking account of progress made in mitigating actions. Although the checklist was focused on the availability of financial services to end-users in the UK, the FPC also considered, where appropriate, risks of disruption to services available to end-users in the EU because the impact of that could spill back to the UK economy.

5. An implementation period would reduce the risks of disruption to the supply of financial services to UK and EU households and businesses as the UK exited the EU. The FPC had been monitoring risks of disruption that could arise in the absence of an implementation period or any other agreement.

6. There had been considerable progress in the UK to address these risks, but only limited progress in the EU. In the limited time remaining, it was not possible for companies on their own to mitigate fully the risks of disruption to cross-border financial services. The need for authorities to complete mitigating actions was now pressing.

7. The UK government was taking forward legislation that would allow UK households and businesses to continue to access financial services provided by EU companies. That legislation needed to be passed by Parliament prior to Brexit to be effective. EU or member state rules would

restrict EU households and businesses from continuing to use some financial services provided by UK firms. In some cases, particularly in insurance, UK financial companies were restructuring so they could continue to serve their EU customers post Brexit. However, actions by firms alone could be only partially effective. Timely action by EU authorities was needed to mitigate risks to financial stability, particularly those associated with derivative contracts and the transfer of personal data. Absent action by EU authorities, EU rules created legal uncertainty about whether EU clearing members could continue to meet their ongoing obligations to UK central counterparties (CCPs) and about the consequences for UK CCPs of continuing to provide services to the EU. To ensure the safe operation of CCPs and avoid financial stability risks, particularly in a stress, the contracts EU clearing members had with UK CCPs would need to be closed out, or transferred, before March 2019. This would be costly to EU businesses and could strain capacity in the derivatives market.

### *Legal frameworks*

- Ensure a UK legal and regulatory framework is in place. Much of the UK's legal and regulatory framework for financial services was derived from EU law. Changes would need to be made to the domestic legal framework to make it workable when the UK was no longer a member of the EU. The EU (Withdrawal) Act had come into force. HM Treasury was legislating for the necessary secondary legislation. The instruments establishing the Temporary Permissions and Recognition Regimes had been presented to Parliament. The FPC judged that the risk to the UK was at a medium level and that there had been a reduction in risk since June.
- Implementation period to allow mitigating actions by firms. Financial institutions would need time to obtain necessary regulatory permissions and complete any necessary restructuring of their operations and re-papering of contracts. In March, the UK Government and European Commission had negotiated a political agreement on an implementation period that would form part of the Withdrawal Agreement, elements of which were still in negotiation. Once finalised and ratified, this would reduce all of the risks set out in the FPC's checklist. The FPC judged that the risk to the UK and to the EU was at a medium level.

### *Preserving the continuity of outstanding cross-border contracts*

- Insurance contracts. The UK government was legislating to ensure that the 16 million insurance policies that UK households and businesses had with EU insurance companies could continue to be serviced by those EU companies after Brexit. That legislation needed to be passed by Parliament prior to Brexit to be effective. EU or member state rules might prevent UK insurance companies collecting premiums from, or paying claims to, their 38 million policyholders in the EU. Most UK insurance companies were making good progress in

restructuring their business in order to serve their EU customers after Brexit. If all current plans were delivered successfully, the number of EU policyholders at risk would fall to 9 million. However, given the volume of restructuring and the process of court approval of plans, there were material execution risks. The FPC judged that the risk to the UK and to the EU was at a medium level, and that there had been a reduction in risk to both the UK and EU since June.

- OTC derivative contracts (uncleared). In the absence of action certain 'lifecycle' events (including amendments, compressions, rolling of contracts, or exercise of some options) could not be performed on cross-border derivative contracts after Brexit. This could compromise the ability of derivative users to manage risks and therefore amplify any stress around the UK's exit from the EU. The UK government was legislating to ensure that these lifecycle events could continue to be performed after Brexit on derivative contracts that UK clients had with EU banks. That legislation needed to be passed by Parliament prior to Brexit to be effective. Once passed, UK clients, such as non-financial companies and asset managers, would avoid disruption to their derivative contracts. However, national rules in some EU member states might prevent certain lifecycle events being performed on derivative contracts that EU clients and banks had with UK banks. These affected contracts accounted for the majority of (uncleared) derivatives between the EU and UK, which had a total notional value of £30 trillion, of which an increasing share (£18 trillion) matured after March 2019. These restrictions would affect the ability of EEA clients and banks, and of UK banks that had the contracts with them, to manage risks in stress. The FPC judged that there had been a reduction in risk to the UK since June but that risks to both the UK and to the EU remained at a high level.
- OTC derivative contracts (cleared). The UK government was legislating to ensure that UK businesses could continue to use clearing services provided by EU-based clearing houses. That legislation needed to be passed by Parliament prior to Brexit to be effective. Under EU law, after March 2019 EU clearing members would be acting unlawfully if they accessed clearing services from UK CCPs, and UK CCPs would not be permitted to provide such services, unless they were recognised by the European Securities & Markets Authority (ESMA). There was therefore legal uncertainty about whether EU clearing members could continue to meet their ongoing obligations to UK CCPs under existing contracts. Any inability to meet obligations would jeopardise the safe operation of CCPs, particularly in an episode of stress. This would amplify any stress around Brexit and increase financial stability risks. There was also uncertainty under EU law and member state law as to the legal consequences for UK CCPs of continuing to provide services to EU clearing members in relation to existing contracts. Absent action by EU authorities to address these issues, the contracts EU clearing members had with UK CCPs would need to be closed out, or transferred, before March 2019.

The ECB estimated EU-based firms cleared 90% of their interest rate swaps in the UK. Overall, EU-based firms had OTC derivative contracts with a notional value of £69 trillion at UK CCPs, an increasing share (£41 trillion) of which matured after March 2019. The movement of a large volume of contracts in a short time frame would be costly to, and disrupt the derivative positions of, EU businesses and could strain capacity in the derivatives market. In addition, fragmentation of central clearing would raise costs for EU businesses. Industry estimates suggested that every single basis point increase in the cost of clearing interest rate swaps alone could cost EU businesses around €22 billion per year. The FPC judged that there had been a reduction in risk to the UK since June but that risks to the UK remained at a medium level, and that risks to the EU remained at a high level.

#### *Avoiding disruption to availability of new financial services*

- Clearing services. The UK government was legislating to ensure that UK firms could continue to use clearing services provided by EU-based clearing houses. That legislation needed to be passed by Parliament prior to Brexit to be effective. Under EU law, EU-based clearing members and trading venues might only access clearing services from UK CCPs after March 2019 where those CCPs were recognised by ESMA. Without such recognition, EU customers would need to make new arrangements with CCPs authorised or recognised by the EU authorities. This created material risks of disruption to those EU customers. The FPC judged that there had been a reduction in risk to the UK since June but that risks to the UK remained at a medium level, and that risks to the EU remained at a high level.
- Banking services. The UK government was legislating to ensure that UK households and businesses could continue to be served by EU-based banks after Brexit. That legislation needed to be passed by Parliament prior to Brexit to be effective. EU or member state rules might prevent EU customers from accessing UK-based banks. EU households and businesses currently relied on UK banks for around half of their wholesale banking services. Although UK banks were in the processes of restructuring and obtaining necessary regulatory permissions to set up operations in the EU, there remained material risks of disruption to EU households and businesses. The FPC judged that risks to both the UK and EU were at a medium level, and that there had been a reduction in risk to the UK since June.
- Asset management. The UK government was legislating for a temporary permissions regime to ensure that funds domiciled in the EEA could be marketed to investors in the UK. That legislation needed to be passed by Parliament prior to Brexit to be effective. EU rules allowed asset managers to delegate the management of their assets to entities outside the EEA when a co-operation agreement was in place between the authorities. In the absence of a co-

operation agreement, there was a risk of changes to asset managers' businesses that could be disruptive. The FPC judged that risks to both the UK and EU were at a medium level, and that there had been a reduction in risk to the UK since June.

- Personal data. The UK government had announced its intention at the point of exit to continue to allow the free flow of personal data from the UK to the EU. Once in effect, this would allow the transfer of personal data to the EU, supporting UK households and businesses in accessing services from, and continuing contracts with, EU-financial service providers. Without equivalent action by EU authorities, EU rules would restrict the flow of personal data from the EU to the UK. This could restrict EU households and businesses in accessing financial services from, and continuing contracts with, UK financial service providers. Although companies could add clauses into contracts in order to comply with the EU's cross-border transfer rules, these were subject to some legal and operational risk. The FPC judged that risks to both the UK and EU were at a medium level, and that there had been a reduction in risk to the UK since June.

8. As the FPC had set out in previous meetings, the checklist was not a comprehensive assessment of risks to economic activity arising from Brexit. It covered only the risks identified to date that could stem from direct disruption to financial services. There were also other risks to economic activity that could arise as a result of, for example, restrictions on exports of goods and services or a reduction in the appetite of foreign investors to provide finance to the UK. The FPC had also been reviewing these risks regularly, including alongside its 2017 stress-test scenario for major UK banks.

9. At its meetings, the Committee considered again the range of adverse economic shocks that could arise as the UK withdrew from the EU and their potential impact on financial stability. The scale and probability of the risks would depend not just on the nature of the new relationship with the EU and the transition to it, but also on many other factors, including the extent of contingency planning and mitigating actions by governments in the UK and EU.

10. Consistent with its remit, the FPC continued to focus on combinations of risks that, even though they might be unlikely to occur, would have the greatest impact on financial stability. In that context, the FPC considered the particular risks that could arise if the UK's relationship with the EU were to move abruptly to default WTO rules without an implementation period. Within that scenario, the Committee focused on outcomes that would be very unlikely to be exceeded in their severity.

11. The shocks the UK could possibly experience included: a sharp decline in trade flows; disruption to the supply side of the economy arising from barriers to cross-border trade and investment; disruption to the provision of financial services and the functioning of financial markets including those for derivatives. There could also be reduced investor appetite for UK assets and a

depreciation of sterling, resulting in higher inflation. Reflecting all of this, uncertainty could be expected to increase and confidence decline. In an un-cooperative outcome, banks could also face higher than expected costs in restructuring their business models.

12. The Committee reviewed a range of model estimates of these Brexit risks.

13. If particularly adverse combinations of these Brexit shocks were to occur, GDP could fall by around 8%. Such a fall in output would be bigger than in the annual cyclical scenario (ACS) stress test but would occur only in the event of major disruption to the supply side of the economy from barriers to cross-border trade and investment. In such a scenario, a greater proportion of the fall in GDP would be accounted for by a shock to supply and, in particular, potential productivity. All else equal, lower productivity would tend to increase labour demand. Reflecting that, unemployment could rise to around 7%, which would be relatively muted compared to the fall in GDP. In very adverse outcomes, residential property prices could decline by around 30%, and CRE prices by around 50%. The interest rates faced by households and businesses could rise by 250 basis points more than the rise in risk-free rates.

14. The Committee noted that its 2017 ACS stress test scenario already contained many of the features of these worst case scenarios. In the stress test, unemployment rose to 9.5%, GDP declined by 4.7%, residential property prices declined by 33%, and CRE prices declined by 40%. The stress test scenario also featured a sudden reduction in investor appetite for UK assets and the sterling exchange rate falling by 27% to its lowest ever level against the dollar. In the stress scenario that pushed inflation up to 5.1% and Bank Rate increased to 4%. Although, in a very severe outcome, the mix of output and unemployment shocks could be different to the ACS stress test scenario, even very severe outcomes were overall unlikely to result in more severe losses for banks than the ACS stress test scenario.

15. The Committee also noted that, in addition to very adverse domestic macroeconomic outcomes, its 2017 ACS stress test scenario contained a severe global recession and stressed outcomes for misconduct costs. As a whole, the 2017 stress test scenario could hence be considered more severe than very disorderly Brexit outcomes.

16. The Committee agreed, under Section 9U of the Bank of England Act, that it was against the public interest to publish this part of its discussion, for the same reasons that it had set out when it

had initially discussed the potential scenarios of macroeconomic impact. It would review this pending developments in the UK's negotiations with the EU.<sup>1</sup>

17. Based on updated analysis and information, the FPC continued to judge that the UK banking system would be strong enough to serve UK households and businesses through a disorderly, cliff-edge Brexit. Consistent with its remit to ensure the financial system was resilient to major shocks, the FPC continued to review estimates of possible 'worst case' economic outcomes associated with Brexit, however unlikely they might be. The FPC continued to judge that the 2017 stress test encompassed an appropriately wide range of UK macroeconomic outcomes that could be associated with Brexit. As it had set out previously, the FPC judged that Brexit risks, including those of a disorderly, cliff-edge Brexit in which there was no agreement or implementation period, did not warrant additional capital buffers for banks. The 2017 stress test scenario included the UK unemployment rate rising to 9.5%, UK residential property prices falling by 33% and UK commercial real estate prices falling by 40%. It also included a sudden loss of overseas investor appetite for UK assets, a 27% fall in the sterling exchange rate index and Bank Rate rising to 4%.

18. The FPC continued its discussion of the financial stability implications arising from possible forms for the future relationship between the United Kingdom and European Union in financial services including those in the Government's White Paper.

19. As the FPC had set out previously, irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibility, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international baseline standards.

### **Other risks to financial stability**

20. The Committee reviewed other financial system and economic developments since its previous meeting in June 2018, to inform its view on the current risks faced by the financial system.

#### *Global vulnerabilities and debt market conditions*

21. The outlook for global growth appeared to have moderated since June and financial conditions had tightened somewhat, particularly in emerging market economies (EMEs). Global

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<sup>1</sup> The text in this and the preceding seven paragraphs was omitted from the version of the Record that was initially published on 17 October 2018. The Committee agreed at its 20 November 2018 meeting to publish this text, for the reasons set out in the Record of that meeting.

growth was expected to remain relatively robust, however. In 2018 Q2, UK-weighted world GDP growth was unchanged at 0.7% on the quarter.

22. The tightening of US monetary policy that had begun in December 2015 had begun to contribute to a tightening in global financial conditions, particularly over the past six months in EMEs. The tightening of US monetary policy was happening in the context of strong demand growth in recent years, which had absorbed spare capacity in the US economy, with little, if any, slack remaining, and rising annual wage growth.

23. The most acute market pressures to date had focused on Turkey and Argentina, which had large current account deficits and high levels of debt. Current account deficits relative to GDP were 6.6% and 5.6% respectively, and in both cases dollar-denominated debt stood at over 40% of GDP. In Turkey, the dollar exposure was largely in the corporate and financial sectors, whereas in Argentina it was concentrated in the government sector. Currencies in both Turkey and Argentina had depreciated by over 20% since the June *FSR*.

24. A more widespread change in risk appetite could expose broader vulnerabilities, including for other EMEs with high debt levels and large current account deficits. Since mid-April, bond and equity fund outflows from a broad group of non-China EMEs had totalled \$29bn and these outflows had been accompanied by some repricing of assets. For example, EME equity markets had fallen by 6% in local currency terms, high yield corporate bond spreads had increased by 124 basis points and there had been broad based currency depreciation against the US dollar. Nevertheless, these portfolio outflows remained relatively small in the context of the \$249bn cumulative net inflows to these countries seen since 2013. And EME corporate bond spreads remained compressed relative to longer-run historical averages. Overall, non-China EME financial conditions, despite some tightening, therefore remained accommodative.

25. UK banks' direct exposures to non-China EMEs as a group were around 134% of common equity Tier 1 (CET1). Within that, CET1 exposures to Turkey and Argentina were small at only 5% and 2% respectively.

26. The imposition of trade barriers by the US and China, although detrimental to the outlook for global growth, did not itself pose a material risk to UK financial stability. But deepening tensions could trigger a further and more severe tightening of global financial conditions. Tariffs were being applied by the US on \$250 billion of Chinese imports, and had been met with Chinese tariffs on \$110 billion of US imports to date. Around \$267 billion of Chinese goods had been identified by the US as potentially subject to further tariffs. These tariffs had come alongside the aluminium and steel tariffs announced by the US earlier in the year, which China had also responded to by imposing additional tariffs.

27. Credit growth in China had continued to slow since June, with annual growth in adjusted total social financing falling to 11.5% in August and non-bank credit growth slowing more sharply to 4.6%. This was likely to reflect, to some extent, Chinese authorities' actions to weigh on credit growth and de-risk the financial system. But debt levels in China remained highly elevated and policymakers faced a trade-off between offsetting any trade-related economic headwinds and managing financial risks. Deepening trade tensions could encourage China to ease domestic financial conditions, and in doing so, encourage a further build-up of risks.

28. UK banks' direct exposures to China and Hong Kong were around 210% of CET1 capital in aggregate.

29. In most advanced economies, financial conditions had tightened by less than in EMEs over the course of the year, and market moves had generally been modest since June. Overall, that still left longer-term interest rates close to historical lows, with estimated term premia – the compensation for holding longer-maturity assets – compressed. The risk therefore remained of a much more substantial snapback in world interest rates and more challenging bank, corporate and sovereign funding conditions.

30. Recent further increases in Italian government bond yields underlined the vulnerabilities created by high public debt levels and interlinkages between banks and sovereigns in the euro area. There remained a risk that a further deterioration in Italy's financial outlook could result in material spillovers to the rest of the euro area and the UK. While UK banks' direct exposures to Italy accounted for only 10% of their CET1 capital, the UK had significant trade and financial exposures to the euro area as a whole.

31. Risks from the US corporate sector remained material, as leverage had continued to increase and underwriting standards had loosened further. Gross debt had increased from 254% of annual earnings in 2015 Q1 to 290% in 2018 Q2, close to 2007 levels. Moreover, there were particular risks associated with the growing proportion of highly indebted US corporates. The stock of leveraged loans – typically loans to firms who had a non-investment grade rating and were highly indebted or were owned by a private equity sponsor – now exceeded \$1 trillion, relative to total corporate debt of around \$8 trillion. There had been a sharp increase in the share of US leveraged lending deals with weaker covenants, where investors accepted fewer safeguards in the event of a deterioration in the debtor company's finances. There was also a risk that true leverage multiples were being under-reported. That could be the case if borrowers in leveraged loan markets inflated their earnings in leverage calculations, for example by assuming future efficiency gains. Such 'add-backs' to earnings calculations had increased recently.

32. The Committee discussed the extent to which the growth in leveraged loans had parallels to the growth in the US subprime mortgage market before the crisis. The global leveraged loan market was larger than – and was growing as quickly as – the US subprime mortgage market had been in 2006. As with subprime mortgages, underwriting standards had weakened, there was significant uncertainty around the ultimate investors in collateralised loan obligation securitisations and hence their capacity to absorb losses, and borrowers would face higher financing costs if interest rates or credit spreads increased. However, the Committee recognised that there were important differences between these two markets. A substantial proportion of subprime mortgages had been financed by relying on short-term wholesale funding, including from money market funds, and there had been an active repo market in subprime mortgage securitisations. Banks had substantial contingent liabilities related to subprime mortgages. This was not the case for leveraged loans. Moreover, unlike for subprime mortgages, there were limited synthetic securitisations of leveraged loans, and collateralised loan obligations were diversified by industry and, for European vehicles, by country.

#### *UK corporate indebtedness*

33. The FPC reviewed risks in the UK corporate sector, which had been influenced, in part, by global debt market conditions. Financial conditions had tightened over the course of the year. For example, sterling investment grade corporate bond spreads were 24 basis points wider than at the end of 2017 and high-yield spreads were 77 basis points higher. Nevertheless, conditions remained accommodative for large companies. Compared to historical averages, the extra compensation investors demanded for the market and credit risk in corporate bonds remained compressed.

34. The Committee was concerned by the rapid growth of leveraged lending. In common with the US and Europe, high investor demand had driven strong growth in UK leveraged loans. Gross issuance of leveraged loans by UK non-financial companies had reached a record level of £38 billion in 2017 and a further £30 billion had already been issued in 2018. Taking high-yield bonds and leveraged loans together, the estimated stock of debt outstanding in UK non-investment grade firms was now estimated to account for about 20% of total UK corporate sector debt.

35. Consistent with global trends, lending terms had loosened in the UK leveraged loan market and the risk appetite of creditors remained strong. The proportion of UK leveraged loans with maintenance covenants had fallen from close to 100% in 2010 to around 20% currently. The average level of gross debt to earnings amongst UK issuers of leveraged loans had also risen in recent years. Mirroring global trends, there was also a risk that the increasing use of ‘add-backs’ to earnings calculations meant that reported leverage multiples understated the true level of risk.

36. Leveraged loans were typically sold to non-bank investors (including to collateralised loan obligation funds), whose ability to sustain losses without materially impacting financing conditions

was uncertain. However, banks retained some exposure and made other loans to the same highly indebted companies. The FPC would assess any implications for banks in the 2018 stress test. Beyond these direct risks to banks, the FPC would also review how the increasing role of non-bank lenders and changes in the distribution of corporate debt could pose risks to financial stability.

37. Despite the rapid growth of leveraged lending, overall UK corporate lending growth was more moderate and had slowed. Overall corporate debt had grown by 5.2% in the year to 2018 Q2. Within that, the stock of bonds issued by UK companies had increased by around 3% in the past 12 months and borrowing by UK companies from UK banks had also been subdued, rising by just 2.7% in the past year. Growth in lending to small and medium-sized enterprises had been slower than for larger companies. These developments were consistent with restrained borrower demand, perhaps reflecting Brexit-related uncertainty. This had limited the overall increase in corporate leverage, despite accommodative conditions in market-based finance. Although overall gross debt to earnings for UK corporates had trended upwards over the past few years, it remained, in aggregate, below its pre-crisis peak and the cost of servicing debt for businesses remained low, supported by low interest rates.

#### *UK external financing*

38. The current account deficit had increased slightly in Q2 to 3.9% of GDP. In its last meeting, the Committee had noted that the financing of the current account deficit had become more risky in recent years. There had been substantial foreign capital inflows and an increasing share of those inflows had been in the more volatile 'other investment' category.

39. Since June, there had been some outflows from the 'other investment' category. Nevertheless, the broader pattern of cross-border flows in recent years had made the UK more vulnerable to a reduction in foreign investor appetite for UK assets, and an associated tightening in credit conditions for UK households and businesses. The UK commercial real estate and leveraged loan markets were particularly vulnerable to this risk.

#### *Household indebtedness*

40. There had been little news in credit supply conditions for the household sector over the past three months: the risk appetite of lenders remained strong. In the mortgage market, lending spreads had fallen substantially over the past few years, and higher loan-to-value (LTV) spreads had fallen most sharply over that longer period. The additional interest rate charged on a 90% LTV mortgage compared to a 75% LTV mortgage had compressed. That had reduced the compensation lenders received for the additional risk associated with higher LTV lending. The proportion of new mortgage lending at LTV ratios above 90% had further increased to 17.8% in 2018 Q2, up from 15.9% in 2015.

The proportion of new mortgages with a loan to income ratio of four or above also remained at historical highs of around 28%. Within that, there were continued signs of a concentration in loan to income multiples just below 4.5, the threshold at which the FPC had introduced a limit on new lending.

41. Despite these very attractive terms, household mortgage borrowing had increased by only 3.1% in the year to August, broadly in line with household disposable income growth. Credit growth had remained stable at around this level over the past two years, with mortgage approvals also remaining broadly stable and annual house price inflation slowing to around 3% in the latest data. The limited growth in credit volumes might reflect soft demand, which in turn might reflect affordability challenges, uncertainty, the squeeze in real incomes and tax changes for additional properties, offset to an extent by some easing of mortgage pricing and non-price terms.

42. The share of households with a mortgage debt service ratio above 40% (the percentage beyond which historical evidence suggested that households were materially more likely to experience repayment difficulties) remained small at 1.3% in 2018 H1. The average share of households in this situation from 1997 - 2006 had been 1.8%.

43. In the consumer credit market, credit supply conditions had remained stable in recent months, following the tightening that had been observed at the Committee's June meeting.

44. Consistent with the tightening in conditions reported in Q1, there were some signs of a slowing in consumer credit growth in the latest data. Lending growth in the year to August 2018 slowed to 8.1% from 8.8% in June and, within that, the growth rate of both credit card borrowing and personal loans ticked down. And if recent monthly growth rates were to persist, this annual growth rate would fall further. The Committee had acted with the Prudential Regulation Committee (PRC) last year to ensure lenders were able to absorb severe losses on consumer credit.

45. The total stock of UK household debt (excluding student loans, where repayment was contingent on levels of income) as a proportion of household income had been 125% in 2018 Q2, around 20 percentage points lower than its peak of 144% in 2008. Although this level of debt relative to income remained high by historical standards, the cost of servicing debt for households remained low, supported by low interest rates.

#### *Overall domestic credit environment*

46. In aggregate, growth in total private non-financial sector credit (excluding student loans) was modest and had slowed somewhat to 3.9% in the year to 2018 Q2. Over the past year, the debt of UK households and businesses had grown only a little faster than nominal GDP. The latest reading

of the UK's credit to GDP gap, measuring the difference between the ratio of credit to GDP and a simple statistical estimate of its long-term trend, remained significantly negative, at -12%. However, as the FPC had observed at previous meetings, the long-term trend on which this was based gave undue weight to the rapid build-up in credit prior to the global financial crisis and was at present, therefore, a less reliable indicator. Although the total private non-financial sector credit to GDP ratio (excluding student loans) remained elevated by historical standards, it had fallen by over 30 percentage points since 2008. Levels of household and corporate debt in the UK relative to incomes therefore remained materially below their 2008 levels, debt servicing burdens remained low and credit growth had slowed.

### **Risk overview and UK CCyB rate decision**

47. In light of these developments, the FPC considered its view of the overall risk outlook and therefore its UK CCyB rate decision.

48. As the Committee had discussed earlier, it continued to judge that the UK banking system would be strong enough to serve UK households and businesses through a disorderly, cliff-edge Brexit. As a result, in line with its assessment in previous quarters, the FPC continued to judge that Brexit risks, including those of a disorderly, cliff-edge Brexit in which there was no agreement or implementation period, did not warrant additional capital buffers for banks.

49. The FPC judged that risks to the UK from global vulnerabilities remained material. As it had discussed earlier, there had been a tightening in global financial conditions, particularly over the past six months in EMEs and the risk of deepening trade tensions could trigger a further and more severe tightening in the future. As the FPC had set out in previous quarters, global risks were relevant when considering the appropriate UK CCyB rate only to the extent that they could have spillover effects for the UK economy – and so UK credit exposures – via global trade and financial and asset price linkages. The 2017 stress test had demonstrated that the UK banking system was resilient to a synchronised global downturn. The 2018 stress scenario also incorporated a synchronised global downturn in output growth and the FPC would review results from that test at its next meeting.

50. Reflecting the substantial increase in its resilience over the past decade, the FPC judged that the UK banking system now had the capacity to absorb, in addition to a disorderly, cliff-edge Brexit, further misconduct costs and stresses that could arise from intensifying trade tensions and a further sharp tightening of financing conditions for emerging markets. At 16.8%, the aggregate Tier 1 capital ratio of major UK banks was around three times that of ten years ago. Losses on a scale that would have wiped out the common equity capital base of the system in 2007 could now be readily absorbed by available capital.

51. Taking into account the developments across the domestic credit environment, the FPC continued to judge that, apart from those related to Brexit, domestic risks remained at a standard level overall.

52. Nonetheless, the risk appetite of creditors remained strong. The Committee was concerned by the rapid growth of leveraged lending, including to UK businesses. There were also signs of strong domestic risk appetite by lenders in the residential mortgage market, including at higher LTV ratios. Borrower demand had been restrained, and as a consequence credit growth had slowed. The FPC would assess the implications for banks of these developments in the 2018 stress test.

53. Consistent with a standard domestic risk environment overall and given the current balance of risks, the FPC agreed to maintain the UK CCyB rate at 1%. The FPC would conduct, as normal, a comprehensive assessment of the resilience of the UK banking system in the 2018 stress test and review the adequacy of the 1% CCyB rate at its meeting on 28 November.

54. The Committee would remain vigilant to developments in the domestic credit environment, as headwinds to credit demand evolved.

## **Libor**

55. In June 2018, the FPC had agreed it would continue to monitor progress and report regularly on developments in the risks associated with reliance on Libor. The Committee was briefed on two important market-led consultation exercises, which had been launched in July. First, the Working Group on Sterling Risk-Free Reference Rates had launched a consultation on the development of a potential forward-looking term benchmark based on the Sterling Overnight Index Average (SONIA) that should help to facilitate transition away from Libor for an important subset of end-users in sterling markets. Second, the International Swaps and Derivatives Association had launched a market consultation on the fallback rate that should replace Libor in derivatives documentation, should Libor cease to be produced. The FPC also noted that in September, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) had written to CEOs of major banks and insurers supervised in the UK asking for the preparations and actions they had been taking to manage transition from Libor to alternative interest rate benchmarks.

56. There had been some signs of switching away from Libor into SONIA and the Secured Overnight Financing Rate (SOFR) in recent market activity. First, the proportion of the cleared sterling interest rate swaps market accounted for by SONIA-referencing Overnight Index Swaps (OIS) had increased over the past year, albeit from a low base. Second, there had been a notable pick up in the monthly volume of SONIA futures since June, though overall it remained small in comparison with the size of the Libor futures market. Third, there had been a number of notable

issuers of products linked to risk-free rates, in the UK and the US, which might catalyse further activity in the future. Despite these positive developments, there remained a number of important challenges for the market and authorities to address related to the reliance on Libor benchmarks. In particular, many new long-dated contracts were still being written with reference to Libor. The FPC would continue to monitor progress and report regularly.

## **Open-ended commercial real estate funds**

57. The FPC discussed the potential UK financial stability risks from open-ended commercial real estate (CRE) funds, in the context of reforms being planned by the FCA. As the FPC had discussed previously, these funds had a structural liquidity mismatch which, in a stress, could create a first-mover advantage, high levels of redemptions and therefore fire-sales of assets – which could amplify any market adjustment. This in turn could affect investment, given that CRE was widely used as collateral for corporate borrowing, and increase losses for lenders. To manage this mismatch between their assets and liabilities, UK open-ended funds had a range of liquidity management tools, including the ability to suspend redemptions from the fund. These tools, however, did not preclude the possibility of fire-sales, and, in stress, could potentially reinforce first-mover advantage, making fire-sales more likely.

58. This dynamic had been illustrated in the run up to and following the EU Referendum in June 2016. CRE funds had faced significant net outflows and transactions had increased by around 20% compared to normal levels, before a number of funds had suspended. Some members noted that some funds had taken time to suspend and had run down their liquidity buffers before doing so, potentially increasing first-mover advantage.

59. Under the FCA's proposals funds would be more likely to suspend redemptions promptly, which could reduce fire-sales of assets. For example, if independent valuers declared 'material uncertainty' on the value of more than 20% of a fund's assets, the fund would need to suspend immediately. The FCA was also proposing guidance to clarify that managers should not accumulate cash in anticipation of unusually high levels of redemptions, but should consider alternative options, including suspending a fund. The reforms also aimed to enhance awareness of liquidity risks and the potential use of suspensions and other liquidity tools, in order to reduce the risk of large-scale redemptions in stress.

60. While these reforms could therefore reduce the risk of fire-sales of assets, they would not definitively remove the first-mover advantage and the associated risks to UK financial stability. And suspensions would need to operate smoothly in order to be effective. Otherwise more frequent

suspensions could increase incentives to exploit first-mover advantage. This would require clarity on how 'material uncertainty' and 'unusual levels of redemptions' should be defined.

61. The Committee noted that the risk of suspension in this specific sector could have a more general impact on redemptions from open ended funds. This had not happened around the EU Referendum. It also noted that other countries had adopted more fundamental reforms to this type of funds, including by mandating longer redemption terms. For instance, Germany had introduced rules requiring investors in open-ended CRE funds to have a minimum two-year holding period and a one-year notice period for redemptions. The FPC had supported the Financial Stability Board's recommendations to address structural vulnerabilities from asset management activities, including that funds' investment strategies should be consistent with the terms and conditions governing redemptions. The FPC noted that funds already had the flexibility to set longer notice periods and that the FCA's proposals provided incentives to do so, for instance by exempting funds with longer redemption terms from some of the proposed reforms on liquidity risk management. To the extent that the market evolved in this direction, this could be beneficial to financial stability.

62. The Committee acknowledged that there were several reasons why open-ended CRE funds in the UK often offered short redemption terms. For example, HMRC rules required them to do so to be eligible as an ISA investment. The Treasury representative explained the rationale for this and noted that there was a strong desire to avoid unnecessary complexity in the ISA rules, given that ISAs were designed to be a simple product for the retail market.

63. On balance, the Committee concluded that, provided they were implemented as intended, the FCA's proposed reforms were beneficial to UK financial stability. To be effective, suspensions needed to operate in a rapid and consistent manner. Members were comfortable that these reforms, if implemented, were likely to be sufficient on the basis of the relatively small size of open ended CRE funds; currently these funds accounted for only 5 percent of CRE investment in the UK. The FCA planned to publish a consultation on these reforms early in October.

64. But if open ended CRE funds continued to grow in importance in the UK – since the financial crisis, UK CRE funds' assets under management had more than doubled and held an increased share of the UK CRE market – the FPC agreed it should revisit the issue, including by investigating more structural changes, such as mandating longer redemption terms.

65. More broadly, the FPC agreed that the proposals were not a general solution to vulnerabilities in other open-ended funds, especially where the underlying liquidity of the assets was much less than the implied liquidity of the funds that offered daily redemption. The Committee would review the

extent of those vulnerabilities through its annual reviews of financial stability risk and regulation beyond the core banking sector and assess whether additional action was needed to address them.<sup>2</sup>

### **Biennial Exploratory Scenario**

66. Under the Bank's approach to stress testing, the Bank would run an additional exploratory scenario alongside the annual cyclical scenario in 2019.

67. The Committee discussed proposals around the appropriate timing of the 2019 scenario. In the past, the Bank had published both stress scenarios alongside the statement of the FPC's March meeting. But recognising the deployment of resources both within the Bank and at private institutions to prepare for Brexit, the FPC, and PRC, decided to delay the Bank's launch of the next BES to September 2019. The Bank expected to publish the results of this exercise alongside the *FSR* in June 2020.

### **Regular / other reviews**

#### *Reciprocation of Belgian macroprudential measure*

68. The FPC considered a recommendation from the European Systemic Risk Board (ESRB) for relevant authorities to reciprocate a risk-weight increase by the National Bank of Belgium on Belgian residential real estate risks by applying the risk-weight increase to certain banks in their jurisdiction. The recommendation applied to institutions with relevant exposures greater than EUR 2 billion. Consistent with this, the FPC decided no action was necessary at this time as no UK credit institution had relevant exposures exceeding the materiality threshold proposed by the National Bank of Belgium.

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<sup>2</sup> The decisions set out in paragraphs 57 to 65 were taken by written procedure on 3 September, following briefing and deliberations in the summer.

The following members of the Committee were present:

Mark Carney, Governor

Jon Cunliffe, Deputy Governor responsible for financial stability

Ben Broadbent, Deputy Governor responsible for monetary policy

Dave Ramsden, Deputy Governor responsible for markets and banking

Sam Woods, Deputy Governor responsible for prudential regulation

Alex Brazier

Anil Kashyap

Donald Kohn

Richard Sharp

Elisabeth Stheeman

Martin Taylor

Andrew Bailey, Chief Executive of the Financial Conduct Authority

Charles Roxburgh attended as the Treasury member in a non-voting capacity.

As permitted under the Bank of England Act 1998, Bradley Fried and Anne Glover were present at the meeting as observers in their role as members of Court.

## ANNEX: PREVIOUS FPC POLICY DECISIONS

### Outstanding FPC Recommendations and Directions

The FPC has no Recommendations or Directions that have not already been implemented.

### Other FPC policy decisions which remain in place

The table below sets out previous FPC decisions, which remain in force, in the setting of its policy tools. The calibration of these tools is kept under review.

Topic	Calibration
<b>Countercyclical capital buffer rate</b>	<p>At its meeting in October 2018, the FPC set the UK CCyB rate at 1%, unchanged from June.</p> <p>The UK has also reciprocated a number of foreign CCyB decisions — for more details see the Bank of England website.<sup>1</sup> Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.</p>
<b>Mortgage loan to income ratios</b>	<p>In June 2014, the FPC made the following Recommendation (14/Q2/2): The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The Recommendation should be implemented as soon as is practicable.</p> <p>The PRA and the FCA have published their approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,<sup>2</sup> and the FCA has issued general guidance.<sup>3</sup></p>
<b>Mortgage affordability</b>	<p>At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates:</p> <p>When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product rate at origination). This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.</p> <p>At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.</p>

<sup>1</sup> <http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx>

<sup>2</sup> <http://www.bankofengland.co.uk/prd/Documents/publications/ps/2014/ps914.pdf>

<sup>3</sup> <https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending>